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No. 80-2204

In the Supreme Court of the United States

October Term, 1981

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D.
GRANT, DECEASED, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR PETITIONERS

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QUESTION PRESENTED

Does the donor of appreciated property, given on condition that the donee agree to pay the resulting gift taxes, realize taxable income upon the donee's payment of the gift taxes?

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OPINIONS BELOW

The opinion of the Court below is reported as *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981). That opinion reversed decisions of the United States Tax Court reported as *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979) and *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980) which had been consolidated in the Court of Appeals for argument and disposition. For convenience, these cases will be referred to as *Diedrich* and *Grant*.

JURISDICTION

The opinion of the United States Court of Appeals for the Eighth Circuit was filed March 4, 1981, and judgment was entered on that day. On March 13, 1981, and March 17, 1981, petitions for rehearing en banc were filed respectively by counsel for *Diedrich* and *Grant*. These petitions were denied by the Court of Appeals on March 27, 1981. Copies of the orders of the Court of Appeals denying the petitions for rehearing are included as Appendix E to the Petition for a Writ of Certiorari at pages A25 and A26. Jurisdiction by writ of certiorari is vested in the United States Supreme Court by 28 U.S.C. §1254 (1976). The Petition for a Writ of Certiorari was filed on June 25, 1981, and the Writ granted by this Court on October 5, 1981.

STATEMENT OF THE CASE

Two separate cases are before the Court on a joint Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit. Both cases were appealed to the Eighth Circuit by the Commissioner of Internal Revenue from adverse decisions by the United States Tax Court. The cases were consolidated in the Eighth Circuit for oral argument and decision. The relevant facts are undisputed and there are no material factual distinctions between the two cases. Accordingly, the factual situation will be described by reference to the *Grant* case.[1]

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1. In the *Diedrich* case, some of the gifts were made to trusts while both gifts in *Grant* were to an individual donee. No trust income was used to pay the gift taxes and this factual difference has not been urged as a basis for a different disposition of the cases.

In 1970, in reliance on existing law, Frances D. Grant gave 50,000 voting trust certificates, representing underlying common stock of BMA Corporation, to her son subject to his express agreement to pay the resulting gift taxes. (App. 5 & 15.) In January, 1971, Mrs. Grant gave an additional 40,000 voting trust certificates to her son subject to the same condition. (App. 5, 16.) The gift taxes on both transfers were due in the spring of 1971 and these taxes, totalling $232,630, were paid by Mrs. Grant's son. (App. 5, 6, 15, 16.)

Mrs. Grant did not report any income in connection with the net gifts in either her 1970 or 1971 federal income tax returns. Upon audit, the Commissioner determined that Mrs. Grant's gifts were, in part, sales of the property to her son, resulting in long-term capital gains,[2] measured by the difference between the gift taxes paid by Mrs. Grant's son and her basis in the voting trust certificates, computed as follows (App. 18, 19):

Gift taxes paid	$232,630.09
Less: Basis in securities transferred	8,742.60
Long-term capital gain	223,887.49
50% deduction for capital gain	111,943.74
Increase in taxable income	$111,943.75

Mrs. Grant filed a petition for redetermination of the proposed deficiencies in the United States Tax Court. In

2. Capital gains are gains from the sale or exchange of property. Section 1222, I.R.C. 1954. The amount of the gain is the difference between the amount of the money and other property received less the taxpayers' adjusted basis in the property. §1001, I.R.C. 1954. The "adjusted basis" is basis less certain adjustments, generally cost less depreciation. §§1011, 1012, 1016, I.R.C. 1954. The basis for property received by gift is the same as in the hands of the donor, increased by adjustments for the gift taxes paid. §1015, I.R.C. 1954.

a Memorandum Opinion filed February 27, 1980, Mrs. Grant's motion for judgment on the pleadings was sustained and the proposed deficiencies were set aside. (Appendix B to Petition for a Writ of Certiorari.) The Tax Court's opinion in favor of the taxpayer in *Diedrich* was filed on February 13, 1980. (Appendix C to Petition for a Writ of Certiorari.) On March 4, 1981, a three-judge panel of the Court of Appeals reversed the Tax Court's decision in each case and entered judgment in favor of the Commissioner. *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981). (Appendix A to Petition for a Writ of Certiorari.)

SUMMARY OF ARGUMENT

The decision of the Eighth Circuit in this case is based upon its finding that petitioners realized a substantial economic benefit upon payment of the gift taxes by the donees of the petitioners' net gifts. The net gift, however, produces no economic benefit to the donor. The amount of the gift tax on a net gift is exactly the same as the amount of the gift tax on an ordinary gift of the net amount where the donor makes payment of the gift tax. The diminution in the donor's estate in both instances is the same. A donor does not profit economically from any gift. He has an economic loss and that economic loss is not reduced by use of a net gift.

The first decision dealing directly with the income tax consequences to the donor of a net gift was *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969). In that case, net gifts were made to trust donees and to individual donees. The Commissioner conceded that a part sale had not occurred with respect to the trust donees and the Court found that a part sale had not taken place to the individual

donees. The Sixth Circuit affirmed. Subsequent to that decision, the Tax Court has ruled in ten separate cases that the donor of a net gift does not realize taxable gain from the disposition of property in a net gift. The Courts of Appeals for the Fourth, Fifth, and Sixth Circuits have affirmed three of those decisions. The Eighth Circuit decision in this case is the sole judicial decision in favor of the government in the net gift cases.

None of the cases relied upon by the Eighth Circuit in reaching its decision involves a net gift. In each instance, a taxable transaction was found to have taken place. The Eighth Circuit placed primary reliance upon this Court's decision in *Crane v. Commissioner*, 331 U.S. 1 (1947), which did not involve any issue as to taxability of the transaction involved, a sale, but rather involved determination of the amount realized by the taxpayer from the sale. The Eighth Circuit also relied on this Court's decision in *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), involving the payment of a corporate officer's income taxes by his employer. Those payments were made as additional compensation for his services and were found to constitute additional taxable income to him. Again, a traditional taxable transaction was involved, *i.e.* the payment of compensation for personal services.

The net gift cases are directly in point. The cases relied upon by the Eighth Circuit are not directly in point and they are inapposite to the Eighth Circuit's decision. In each case involving the conveyance of property subject to an encumbrance, the taxable transaction or event has been the conveyance. The Eighth Circuit did not find the gift transfers here to be taxable and cases finding the transfer of property subject to encumbrances taxable do not support the Eighth Circuit's decision. The net gift cases were correctly decided and should be followed.

The economic benefit found by the Eighth Circuit to exist in the net gift cases is the discharge of the donor's gift tax liability by the donee. In the net gift, the donor places at the disposal of the donee properties sufficient to pay the gift taxes and secures from the donee an agreement to make the required payment. The donee is a conduit of the donor in making the tax payment and in doing so he is acting for the account of the donor. Legally and economically, the donor has paid the gift taxes. It is of no economic benefit to him that tender of payment is made by the donee and there is no economic loss to the United States Treasury in receiving the tax payment from the donee.

The net gift decision in *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), was made by the Tax Court in 1968. The decision has been followed uniformly by the Tax Court and also by the Courts of Appeals until the decision of the Eighth Circuit in this case twelve years later. The Tax Court has special competence in dealing with tax matters, and its ruling on the law in *Turner* and in this case is supported by reason and precedent and should be followed.

The decision in *Turner* was substantially influenced by the position taken by the Commissioner in earlier gift cases involving the transfer of property into trusts. In those cases, the Commissioner asserted there had been no part gift, part sale, but rather the retention of an income interest in the trust. Under these circumstances, fair play and uniform administration of the tax laws will be served by a decision of this Court following the net gift decisions and rejecting the theory advanced by the Eighth Circuit. The matter has gone too far, too long, to begin anew.

Additionally, in the 1976 Tax Reform Act Congress focused on the possible tax loss when low basis, highly ap-

preciated property is given to low basis taxpayers and enacted section 644 of the Internal Revenue Code. Section 644 places limitations on "bracket advantage," but it does not affect net gifts. In light of the decision in *Turner*, the failure of Congress to expressly include net gifts in section 644 indicates it did not believe a tax on net gift transfers is appropriate.

However, even if this Court feels compelled to affirm the decision of the Eighth Circuit, the same considerations discussed above support a determination by this Court to make its decision prospective only. The petitioners in this case and the other taxpayers awaiting the outcome of this case should not be penalized for structuring their tax planning in accordance with the decision of the Tax Court in *Turner*, as affirmed by the Sixth Circuit, and from which no petition for a writ of certiorari was filed with this Court.

ARGUMENT

A. Question Presented.

The question presented in this case is whether or not the donor of appreciated property, given on condition that the donee pay the resulting gift taxes, realizes taxable income upon the donee's payment of the gift taxes. The term "net gift," as used in this brief, refers solely to this specific transaction. It does not refer to a transfer of property subject to an indebtedness, to a transfer of property in exchange for a transfer of money to the donor, or to any other transfer. The only transaction which this Court is asked to examine is one in which the donee's sole obligation is payment of gift taxes to the Treasury.

The Commissioner's theory of taxation is that payment of the gift taxes by the donee is a real and substantial economic benefit to the donor which is taxable as income under

section 61 of the Internal Revenue Code. Section 61 defines gross income generally as income from whatever source derived, including gains from dealings in property. The Commissioner further theorizes that the donor's income arises from the sale or other disposition of property and the amount, determined under section 1001, I.R.C. 1954, is equal to the difference between the gift taxes paid and the donor's adjusted basis in the property. The taxpayers claim that a gift was made—nothing more, nothing less. A gift of appreciated property under these circumstances does not result in income to the donor. *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964).

B. Economics of a Net Gift.

There are only two factual situations in which a net gift will result in tax savings to a family unit. First, if it is necessary to sell some portion of the property to pay gift taxes and the donee is in a lower tax bracket than the donor. Second, if the donor and the donee want to avoid selling any of the property and a sale would be necessary if the gift taxes are paid by the donor, but not if they are paid by the donee who has or can arrange for the necessary funds. A net gift in this situation will permit the family unit to defer recognizing gain on the property until it is sold or exchanged by the donee in a taxable transaction.

For gift tax purposes, the gift tax is imposed on the net amount received by the donee. This is the difference between the total value of the property transferred and the amount of the gift taxes. Rev. Rul. 75-72, 1975-1 C.B. 310. For example, if a net gift of $1,000 is made by a donor in a 25% bracket, the gift portion, represented by "X" in this example, would be as follows:

$$\begin{aligned} X + .25X &= \$1{,}000 \\ 1.25X &= \$1{,}000 \\ X &= \$\ 800 \end{aligned}$$

The donor has made an $800 gift for gift tax purposes and the gift tax is $200 (.25 x $800). In this example, the $1,000 net gift produces the same gift tax as an $800 gift where the taxes are paid by the donor. The donor, the donee, and the U. S. Treasury are all in the same economic position.

The following examples compare ordinary gifts and net gifts under various circumstances. In the examples, the donor owns stock having a value of $1.00 per share. The donor has a zero basis in this stock, for capital gains purposes, and he is in a 25% gift tax bracket. Capital gains are taxed at an effective rate of 25% for the donor and at 10% for the donee.

In Example I, neither the donor nor the donee is required to sell stock to pay the gift taxes.

EXAMPLE I

	Donor's Estate		Donee's Estate	
	Stock	Cash	Stock	Cash
A. *Ordinary Gift*				
Before Gift	1,000 Shares	$ 200		$ 200
Gift	(800)		800 Shares	
Gift Tax		(200)		
After Gift	200 Shares	$ —	800 Shares	$ 200
Total Estate	$ 200		$1,000	
B. *Net Gift*				
Before Gift	1,000 Shares	$ 200		$ 200
Gift	(1,000)		1,000 Shares	
Gift Tax				(200)
After Gift	— Shares	$ 200	1,000 Shares	$ —
Total Estate	$ 200		$1,000	

In Example I, the economics to the donor, to the donee and to the U.S. Treasury are the same. The only difference is the makeup of the two estates after the gift. The reasons for the net gift, in this example, are to preserve cash in the donor's estate and to confer upon the donee the benefits of owning the stock, *i.e.* dividends, future appreciation and right to vote. This is basically the *Grant* case. There are no tax avoidance motives. ***The donor receives no economic benefit as a result of the donee's payment of the gift taxes.***

The following example shows the result of a net gift when the donor lacks sufficient cash to pay the gift taxes and is required to sell stock if an ordinary gift is made.

EXAMPLE II

	Donor's Estate		Donee's Estate	
	Stock	Cash	Stock	Cash
A. *Ordinary Gift*				
Before Gift	1,000 Shares	—	—	$ 200
Sale	(250)	$250		
Gains Tax		(63)		
Gift	(750)		750 Shares	
Gift Tax		(187)		
After Gift	— Shares		750 Shares	$ 200
Total Estate	—		$ 950	
B. *Net Gift*				
Before Gift	1,000 Shares	—		$ 200
Gift	(1,000)		1,000 Shares	
Gift Tax				(200)
After Gift	— Shares	—	1,000 Shares	—
Total Estate	—		$1,000	

The economics to the donee and to the Treasury in Example II are different. The ordinary gift has resulted in a capital gains tax being paid the Treasury and a corresponding reduction in the amount received by the donee. *Still the donor receives no economic benefit as a result of the donee's payment of the gift taxes.*

In the final example, neither the donor nor the donee has sufficient cash to pay the gift taxes.

EXAMPLE III

	Donor's Estate		Donee's Estate	
	Stock	Cash	Stock	Cash
A. *Ordinary Gift*				
Before Gift	1,000 Shares	$ —	—	—
Sale	(250)	250		
Gains Tax		(63)		
Gift	(750)	—	750 Shares	
Gift Tax		(187)		
After Gift	— Shares	—	750 shares	—
Total Estate	—		$750	
B. *Net Gift*				
Before Gift	1,000 Shares	—	—	—
Gift	(1,000)		1,000 Shares	
Sale			(222)	222
Gains Tax				(22)
Gift Tax				(200)
After Gift	— Shares	—	782 Shares	—
Total Estate	—		$778	

In Example III, some of the stock has to be sold in any event to pay the gift taxes and the total taxes are higher if the sale is made by the donor. This is basically the *Diedrich* case. If the donor and the donee were in the same tax brackets for capital gains, the total taxes would have been the same. As in Examples I and II, *the donor receives no economic benefit as a result of the donee's payment of the gift taxes.*

As shown in these examples, the net gift does not result in any economic benefit to the donor. The economic reality is that the donor can afford to reduce his estate by a certain amount—whether it be in the form of gift property, gift taxes, or capital gains taxes. Where the donor is taxed at capital gains rates higher than those of the donee and some of the property has to be sold, the net gift will produce a lower capital gains tax. The person who benefits is the donee. In any event, the donor has not profited. Economically, he is neither better off nor worse off. The net gift simply helps maximize the amount retained by the donee.

The Commissioner's "substantial economic benefit" theory was considered and rejected by the Fourth Circuit in *Hirst v. Commissioner*, 572 F.2d 427 (4th Cir. 1978), as follows: "Before the present transaction, Mrs. Hirst owed nothing and by virtue of the transaction she received nothing. She was not better off after the transfer, with the donee undertaking the burden of the gift tax; she was simply not worse off." *Id.* at 431. That analysis is equally applicable to the taxpayers here, and the benefit theory should be rejected here.

C. The Eighth Circuit Decision in This Case.

The Eighth Circuit's decision in this case is based upon its conclusion that a "benefit" inured to the donor upon payment of the gift tax liabilities by the donees.

> We agree with District Judge Thomsen's dissent in *Hirst*, joined by two members of the en banc court, that when the donor's gift tax liabilities were discharged by the donees, the benefit conferred resulted in taxable income. Here, as in *Hirst*, "[t]he effect of what was done * * * is the same as though [the donees] had paid the money directly to taxpayer[s] and [they] had used it to discharge [their] gift tax liabilities."

643 F.2d at 504 (footnote omitted). The Eighth Circuit believed that *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), had been incorrectly decided and that the correct approach was that taken in *Johnson v. Commissioner*, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974), and *Estate of Levine v. Commissioner*, 634 F.2d 12 (2nd Cir. 1980).

D. Previous Net Gift Decisions.

The Commissioner's position had been rejected in every net gift case in which it was litigated prior to the Eighth Circuit decision in this case.[3] *See McNeice v. Commissioner*, 41 T.C.M. (CCH) 969 (1981); *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980), *rev'd*, 643 F. 2d 499 (8th Cir. 1981); *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979), *rev'd*, 643 F.2d 499 (8th Cir. 1981); *Estate of Weeden v. Commissioner*, 39 T.C.M. (CCH) 699 (1979), *appeal docketed*, No. 80-7127 (9th Cir.); *Benson v. Commissioner*, 37 T.C.M. (CCH) 989 (1978), *appeal docketed*, No. 79-1032 (6th Cir.); *Bradford v. Commissioner*, 70 T.C. 584 (1978), *appeal docketed*, No. 79-1094 (6th Cir.); *Estate of Henry v. Commissioner*, 69 T.C. 665 (1978),

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3. On March 24, 1981, the United States District Court for the Northern District of Iowa found for the Commissioner in a net gift case on the basis of *Diedrich*. *Molinaro v. United States*, No. 79-2040 (D. Iowa, filed March 24, 1981) [81-1 U.S.T.C. (CCH) ¶9362].

appeal docketed, No. 78-1340 (6th Cir.); *Owen v. Commissioner*, 37 T.C.M. (CCH) 272 (1978), *aff'd*, 652 F.2d 1271 (6th Cir. 1981); *Hirst v. Commissioner*, 63 T.C. 307 (1974), *aff'd*, 572 F.2d 427 (4th Cir. 1978); *Estate of Davis v. Commissioner*, 30 T.C.M. (CCH) 1363 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972); *Krause v. Commissioner*, 56 T.C. 1242 (1971), *appeal dismissed* (6th Cir. 1972); *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969).

Turner v. Commissioner, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), is the leading case. In *Turner*, gifts of corporate stock were made to various individuals and trusts subject to the donees agreeing to pay the resulting gift taxes. The funds for paying the taxes were raised by the donees in a variety of ways. The Commissioner asserted an income tax deficiency against the donor on the theory that each transfer was a part sale, part gift. The Tax Court rejected the Commissioner's theory, concluding that the transfers were gifts only and did not result in any taxable gain to the donor. The decision was affirmed, *per curiam*, by the Court of Appeals for the Sixth Circuit. *Turner v. Commissioner*, 410 F.2d 752 (6th Cir. 1969). This case is the basis for all subsequent net gift decisions.

The next major decision was *Estate of Davis v. Commissioner*, 30 T.C.M. (CCH) 1363 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972). There the taxpayers transferred a substantial amount of corporate stock directly to one of their sons and in trust for the benefit of two other sons. The three donees signed an agreement whereby they assumed and agreed to pay whatever gift tax was imposed by reason of the gift. The Tax Court stated that the issue, with respect to the gift to the individual, was whether the conditional transfer was a net gift, as con-

tended by the taxpayer, or a part sale, part gift, as contended by the Commissioner. *Id.* at 1366. After considering all of the evidence, the Tax Court concluded that there was nothing in the facts before it which could be construed to indicate anything other than a net gift. *Id.* at 1367. Therefore, relying on various other Tax Court decisions, including *Turner*, the Tax Court concluded that the condition imposed by the transferor that the transferees pay the resulting gift taxes did not alter the result—the transfer constituted a gift. The Tax Court's decision was affirmed, *per curiam*, by the Fifth Circuit Court of Appeals. *Estate of Davis v. Commissioner*, 469 F.2d 694 (5th Cir. 1972).

Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978), was the last decision from the Courts of Appeals before this case was decided by the Eighth Circuit. The taxpayer in *Hirst* was an 81 year old widow who made outright gifts of real property to her son and two grandchildren and a gift in trust to a third grandchild who was still a minor. The son agreed to pay the resulting gift taxes. None of the real property was subject to any lien or indebtedness and its basis was considerably less than the gift taxes. The Tax Court followed *Turner* and rejected the Commissioner's argument that the donee's agreement to pay gift taxes was a taxable event. On appeal a majority of the three-judge panel voted to reverse the Tax Court. However, the case was reheard *en banc* before the decision of the panel was filed, and the Fourth Circuit, by a vote of five to two, affirmed the Tax Court's decision.

The majority opinion of the five judges in *Hirst* is embodied in the combined opinions of Chief Judge Haynsworth and Senior Judge Bryan. The majority found as follows:

> The predominant circumstance here is that this taxpayer did not intend to sell anything; she intended only

> to give her property to her progeny. She did not receive anything for herself; there was no economic gain of any kind accruing to her, except release from the normal tax burden of an owner of real estate.

572 F.2d at 430 (footnote omitted). Based on the above, Judge Haynsworth concluded: "Before the present transaction, Mrs. Hirst owed nothing and by virtue of the transactions she received nothing. She was not better off after the transfer, with the donee undertaking the burden of the gift tax; she was simply not worse off." *Id.* at 431. Likewise, Judge Bryan stated:

> For me these facts unalterably demonstrate that the transfer was a gift and nothing more; it did not result in income. The Tax Court's determination to this effect, it seems to me, should be allowed to stand. The partition of the agreement into a gift and an income-producing transaction was not justified in the circumstances.

Id. at 431-32.

Owen v. Commissioner, 652 F.2d 1271 (6th Cir. 1981), is the most recent case decided in the Courts of Appeals, the decision having been rendered on June 23, 1981. In that case, highly appreciated corporate stock was transferred in trust for the benefit of the grantors' five grandchildren. The trust instrument provided that the trustee was to pay all federal and state gift taxes arising out of the transfers and the tax obligations were discharged with funds borrowed by the trust. The trust subsequently sold a portion of donated gift stock to repay the loans. The Tax Court ruled for the taxpayer and a three-judge panel of the Sixth Circuit affirmed in a two-to-one decision. The Court considered *Owen* indistinguishable from *Turner* and ruled in favor of the taxpayers on the basis of *stare decisis*. *Id.* at 1278.

In view of the other cases decided by the Tax Court and affirmed by the Courts of Appeals, the decision in *Owen* is not surprising. The decision is, however, significant because the Sixth Circuit recognized that its decision in *Johnson v. Commissioner*, 495 F.2d 1079 (6th Cir. 1974), which is discussed below, did not overrule *Turner*. *Turner* is the law of the Sixth Circuit on net gifts.

The Tax Court and the Courts of Appeals for the Fourth, Fifth, and Sixth Circuits have followed *Turner*, on its facts, in an unbroken line of cases. The decision of the Eighth Circuit in this case is the sole exception. These other cases hold that the donor of a net gift does not recognize income upon the donee's payment of the gift taxes. They hold that the transaction in question is a gift, a transaction without income consequences to the donor. A gift is not a sale in which there is no gain; a gift is not a sale in the first place.

E. The Cases Upon Which the Eighth Circuit Relied.

As mentioned earlier, in its decision the Eighth Circuit relied on *Johnson v. Commissioner*, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974), and *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2nd Cir. 1980). Those cases, in turn, were based upon decisions of this Court in *Crane v. Commissioner*, 331 U.S. 1 (1947), and *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), and on lower court decisions in *Malone v. United States*, 326 F.Supp. 106 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972); *First National Industries, Inc. v. Commissioner*, 404 F.2d 1182 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969); and *Simon v. Commissioner*, 285 F.2d 422 (3rd Cir. 1960). Although there was no discussion of the case, the Eighth

Circuit also made reference to the decision in *Evangelista v. Commissioner*, 629 F.2d 1218 (7th Cir. 1980). These cases are the foundation of the Commissioner's arguments in the net gift cases. *None involves a net gift.*

Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929), involved an interpretation of the Revenue Act of 1918. Petitioner was the executor of the estate of William N. Wood, deceased, who had been the president of American Woolen Company. For the years 1919 and 1920, the company paid all state and federal income taxes on the salaries of the officers, including Mr. Wood. The Commissioner assessed additional income taxes against Mr. Wood on the basis of the company's payment of his taxes. The Supreme Court held that payment of the taxes was in consideration of the services he rendered as an employee and were therefore taxable to him. *Id.* at 729. A net gift was not involved; compensation for services rendered was involved.

In *Crane v. Commissioner*, 331 U.S. 1 (1947), Mrs. Crane acquired property subject to a mortgage equal to its fair market value. She included the mortgage as a part of her basis and depreciated the property for a few years. She then sold the property for $2,500, subject to the mortgage, and reported a gain of $2,500 on the transaction. The Supreme Court held that the taxpayer realized $2,500 upon the sale plus an amount equal to the balance due on the mortgage even though she had no personal liability for the indebtedness. The rationale for its holding was expressed as follows:

> We are . . . concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his

> personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

Id. at 14.

The decision in *Crane* was easy. If Mrs. Crane had the right to include the mortgage as a part of her basis in the property, for depreciation purposes, how could she argue realistically that she did not receive a corresponding amount when the property was conveyed? *Crane* involved only the *amount* of the gain; the taxability of the transaction was not in issue. A net gift was not involved; gain from the sale of property was involved.

The reasons *Crane* does not apply to this case are well articulated in the portion of the Commissioner's brief in *Johnson v. Commissioner*, in which he distinguished *Turner*. There, the Commissioner said:

> *Turner* involved altogether different transactions. . . . We submit that the *Turner* decision is inapplicable here, but if this Court concludes that *Turner* is relevant, we submit that it should not be followed for the applicability of *Crane* and *First National Industries* to the case is far clearer. (p. 6)
>
> * * *
>
> *Turner* is distinguishable from [*Johnson*]. . . . *Turner* did not involve the *Crane* and *First National Industries* - type transactions as [*Johnson* does]. . . . [T]he transferror in *Turner* did not realize any *gain* at the time of the transfer, when she received a mere unsecured promise to pay the gift tax due, [accordingly] the [*Turner*] case [does] not fit any familiar

> pattern such as the *Crane*-type transaction involved here. (p. 15)
>
> * * *
>
> It bears repeating that these [*Johnson*] cases fit the classic *Crane*-type mold, rather than that of *Turner*, and should be decided on that basis. (p. 20)
>
> * * *
>
> Even apart from the applicability of *Crane*, moreover, a decision that *Turner* controls the outcome here would constitute an effective overruling of this Court's own decision in *First National Industries*. (p. 21)

The reason *Johnson* fits *Crane* is that a pre-existing liability was discharged. That was not the case in *Turner*, nor is it here.

In *Malone v. United States*, 326 F.Supp. 106 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972), the taxpayer made a gift of land subject to $32,000 in mortgages which secured personal borrowings of the taxpayer. The funds had been used for his personal benefit. Principal and interest on this indebtedness was subsequently retired by the donee from earnings off the land. Because of the taxpayer's personal exclusions, no gift taxes were payable. The Commissioner asserted that the transaction was part gift and part sale. The Court agreed, concluding that the trust had effectively assumed the donor's obligations on the notes and that he had thereby secured a discharge of his personal indebtedness which constituted taxable gain. A net gift was not involved; a sale or exchange was involved.

In *First National Industries, Inc. v. Commissioner*, 404 F.2d 1182 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969), the taxpayer was one of six corporations owned or con-

trolled by a charitable foundation. The taxpayer owned stock in an entirely separate company which it pledged as collateral for a $750,000 bank loan. The pledged stock was then donated to the charitable foundation. The foundation sold the stock for $700,000 and used the proceeds to pay off loans it had obtained from the other related corporations. Those corporations were indebted to the taxpayer and they paid the $700,000 received from the foundation to the taxpayer on their debts. The taxpayer then used the funds to retire the original bank loan. The Court found in favor of the government:

> We hold that the determination of the Tax Court that the transaction whereby petitioner transferred the stock to the Foundation was a sale by petitioner of the stock for an amount of at least $700,000 and that petitioner thereby realized a capital gain from the transaction in its fiscal year ended January 31, 1959, to be supported by substantial evidence and not clearly erroneous.

404 F.2d at 1186. A net gift was not involved; a sale of property was involved.

In *Simon v. Commissioner*, 32 T.C. 935 (1959), *aff'd*, 285 F.2d 422 (3rd Cir. 1960), the taxpayer purchased the RKO building in Philadelphia. He placed a non-recourse mortgage on the property in the amount of $120,000 and shortly thereafter conveyed the property subject to the mortgage to a corporation as a contribution to its capital. The Tax Court found, as its ultimate fact determination, that a sale took place, and that finding was affirmed by the Court of Appeals. A net gift was not involved; a sale of property was involved.

Johnson v. Commissioner, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974),

was a typical *Crane* case except that the property was given away rather than sold. In *Johnson*, the taxpayers obtained a $200,000 loan secured by a pledge of corporate stock. Three days later the stock was transferred in trust for the benefit of the taxpayers' children. The taxpayers' loan was paid off by the trust and the taxpayers (not the donees) paid the gift taxes of approximately $150,000, leaving them with $50,000 in cash and no obligation on the note. The taxpayers reported no income from the transaction. The Commissioner assessed an income tax deficiency based upon the taxpayers' receipt of $200,000 from the discharge of the loan.

In the resulting litigation, the taxpayers conceded they had realized income to the extent of $50,000, but maintained they did not realize income to the extent loan proceeds had been used to pay gift taxes. The taxpayers argued that their transaction was in substance no different than the net gift made in *Turner* and that no income should be recognized to the extent of the gift taxes. The Tax Court disagreed, holding that to the extent the loan exceeded their basis in the property, there was a sale. 59 T.C. at 812. The Sixth Circuit affirmed. 495 F.2d 1079.

The *Johnson* case differs from *Malone v. United States*, only in that part of the loan proceeds were used to pay the gift taxes. The taxpayer conceded he recognized gain to the extent of the excess, *i.e.* $50,000 and he thus conceded that the transaction was taxable. What Johnson was seeking actually was a deduction in the amount of $150,000 for the gift taxes he paid. Such a deduction is specifically denied by section 275 of the Internal Revenue Code and Johnson had no case. A net gift was not involved in *Johnson;* a sale was involved.

The Court of Appeals in *Johnson* disposed of the *Turner* argument as follows: "[T]he *Turner* case does

not support the taxpayers' position. *Turner* has no precedential value beyond its peculiar fact situation, in view of the Commissioner's concessions in that case both in the Tax Court and on appeal to this Court." 495 F.2d at 1086.

The "concessions" referred to were admissions by the Commissioner that the transfers to the trusts were not part gift, part sale. No concessions were made with respect to the net gifts made in *Turner* to individuals, however, and the *Turner* ruling as to net gifts remained intact. In every subsequent net gift case, the Commissioner has claimed that *Johnson* overruled *Turner*. That argument has now been laid to rest with the decision in *Owen v. Commissioner*. (See discussion at pp. 16-17, *supra*.)

Evangelista v. Commissioner, 629 F.2d 1218 (7th Cir. 1980), also involved a *Crane*-type transaction. The taxpayer in *Evangelista* owned a fleet of automobiles which were leased to the United States government. The automobiles were encumbered by an indebtedness of approximately $100,000 on which the taxpayer was personally liable. He owned the automobiles for parts of two tax years during which he claimed approximately $68,000 in depreciation deductions. The automobiles and the government leases were then transferred to a trust established for the benefit of his children. At the time of the transfer, the taxpayer's basis in the automobiles was approximately $34,000, and the unpaid balance of the indebtedness was approximately $67,000. The taxpayer did not report any income in connection with the transfer and he did not report the transfer as a gift.

The Seventh Circuit determined that gain had been realized to the extent the assumed indebtedness exceeded the taxpayer's adjusted basis in the automobiles. The Court held there was no evidence in the record to support

the taxpayer's contention that a gift had been made and, accordingly, there was no need to consider the taxpayer's argument that he had made a net gift. The Tax Court had determined that a taxable disposition had taken place and the Seventh Circuit agreed. *Id.* at 1224. A net gift was not involved; a sale or exchange was involved.

The taxpayer in *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980), made a gift of land to a trust for the benefit of three grandchildren. The trust assumed almost $800,000 in pre-existing, non-recourse debt which encumbered the land and approximately $125,000 of pre-existing expenses incurred by the donor. The donor had retained more than $200,000 of mortgage proceeds for his personal use and he reported a gift of approximately $15,000. The Tax Court found the transfer to be part gift, part sale. 72 T.C. at 791. The Second Circuit affirmed following the Sixth Circuit's lead in *Johnson* and refusing to apply *Turner* to this non-net gift transaction. 634 F.2d 12. The Court found there was an explicit "sale" element to the transaction. *Id.* at 17. A net gift was not involved; a sale was involved.

All of the cases relied upon by the Eighth Circuit, with the exception of *Old Colony Trust Co. v. Commissioner*, 219 U.S. 716 (1929), involve the conveyance of property subject to an indebtedness. The taxable event in each of these cases is the conveyance; it is not payment of the obligation by the transferee. The Commissioner does not assert, and the Eighth Circuit did not find, that the transfers by gift in these cases were the taxable events. The Eighth Circuit held the taxable event to be the subsequent discharge of the gift tax liability. Only *Old Colony Trust Co.*, even by analogy, supports that holding; *Old Colony Trust Co.* is not applicable because the payment of taxes in that case was specifically in consideration of services rendered.

The payments in this case by the donees is in satisfaction of their obligations under agreements made in connection with nontaxable transfers.

Thus, the cases relied on by the Eighth Circuit do not support its economic benefit theory. *Crane* and *Old Colony Trust Co.* involve traditional taxable transactions. *Johnson, Levine,* and *Evangelista* were all decided by the Tax Court after *Turner* and each involved a sale. The Tax Court has consistently followed *Turner,* and it found no difficulty reconciling its subsequent decisions in *Johnson, Levine,* and *Evangelista* with *Turner.* A net gift is not a sale. In both cases before the Court here, the Tax Court found that a gift had been made of the entire property (Appendix B to Petition for a Writ of Certiorari at A14; Appendix C to Petition for a Writ of Certiorari at A17); there was no finding of a part gift, part sale.

F. Discharge of the Gift Tax Liability in a Net Gift Is Made by the Donor.

The "economic benefit" to the donor invented by the Commissioner and adopted by the Eighth Circuit is the discharge of his gift tax liability by the donee. *Diedrich v. Commissioner,* 643 F.2d at 504. As explained earlier, there is no economic benefit to the donor. Similarly, there is no independent taxable value received by the donor because payment of the taxes is tendered by the donee. Section 2501, I.R.C. 1954, imposes a tax "on the transfer of property by gift." Section 2502(d) states that the tax shall be paid by the donor. Although legal responsibility for attending to payment is thus placed on the donor, nowhere does the Code require tender of payment by the donor or, for that matter, specify the source of funds to be used.

The donor of a net gift makes legally enforceable arrangements for payment of the gift taxes. He supplies

funds with which the payment can be made. The donee accepts those funds and holds them subject to an obligation to tender payment of the gift taxes. When he does so, he is performing a duty on behalf of the donor and the payment is for the account of the donor. It is immaterial that the donee may choose to use other property for payment of the taxes. *See, Estate of Morgan v. Commissioner*, 37 T.C. 981, 985 (1962), *aff'd per curiam*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963). Neither the donor nor the Treasury is affected.

Assume a donor in a 25% gift tax bracket makes a net gift of $1,000 in cash. The gift is $800; $200 and has been deposited with the donee to cover the tax. The donor has not incurred an income tax liability when the donee tenders the gift taxes to the Treasury.[4] *Krause v. Commissioner*, 56 T.C. at 1248. This is not a taxable transaction in which there is no gain; it is not a taxable transaction at all. Legally and economically, the donor has paid the gift taxes. We submit that the transaction is no different substantively because low basis corporate stock is given rather than cash.

If an employee, in exchange for services rendered, directs his employer to pay the employee's debt, the payment is income to the employee. It is compensation for services rendered. *Old Colony Trust Co.* If, however, a mother deposits money with her son and directs him to pay her gift taxes, the payment is not income to the mother. Discharge of the tax liability—as opposed to tender of payment—is made by the mother.

The donee's status as a conduit for payment of the gift taxes was recognized in *Turner* where the Tax Court stated

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4. In footnote 13 to his brief before the Eighth Circuit in *Diedrich*, the Commissioner conceded no taxable income would be generated in this situation.

that the effect of the net gift transfer is to reserve a right to use a portion of the property. 49 T.C. at 363. That rationale has not been criticized in the subsequent decisions considering *Turner*. It is of no importance to the donor or to the Treasury whether the donee pays the taxes (a) by selling some of the property, (b) by borrowing the funds, or (c) by using funds independently obtained.

G. The Role of Stare Decisis.

Reversal of the Eighth Circuit is appropriate under the principles of fair play, uniform administration of the tax laws, and *stare decisis*. We have analyzed the past net gift decisions and the cases relied upon by the Eighth Circuit in detail. The net gift decisions all favor the taxpayer. None of the cases relied on by the Eighth Circuit involves a net gift; all involve traditional income producing transactions. Whatever may be said of the merits of the Commissioner's position, the matter has gone so far, for so long, that it should not now be reversed.

> Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

United States v. Byrum, 408 U.S. 125, 134 (1972). "Things have gone too far by now to wipe the slate clean and start all over again." *Hirst v. Commissioner*, 63 T.C. at 315.

In *Estate of Henry v. Commissioner*, a net gift case, the Tax Court recognized that it would be unfair to impose a tax upon a taxpayer who in good faith relied on existing law:

> Despite this overwhelming precedent to the contrary, respondent [Commissioner] continues to urge that we change our long-established position on this issue in order to sustain a tax deficiency . . . against a taxpayer who justifiably relied upon that clear precedent in making the gifts which are the subject of this case. . . . In these circumstances, under the principle of stare decisis and fair play with a taxpayer who has relied upon our prior opinions, which opinions have been affirmed by higher courts or in respect of which appeals have been dismissed, we must follow the *Turner* case and hold that petitioner did not realize taxable income as a result of the conditional transfers here in dispute.

69 T.C. at 675.

In *Dobson v. Commissioner*, 320 U.S. 489 (1943), the Supreme Court stated with respect to decisions of the Tax Court:

> Congress has invested the Tax Court with primary authority for redetermining deficiencies, which constitutes the greater part of tax litigation. This requires it to consider both law and facts. Whatever latitude exists in resolving questions such as those of proper accounting, treating a series of transactions as one for tax purposes, or treating apparently separate ones as single in their tax consequences, exists in the Tax Court and not in regular courts; when the court cannot separate the elements of a decision so as to identify a clear-cut mistake of law, the decision of the Tax

> Court must stand. . . . In deciding law questions courts may properly attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter. The Tax Court is informed by experience and kept current with tax evolution and needs by the volume and variety of its work. While its decisions may not be binding precedents for courts dealing with similar problems, uniform administration would be promoted by conforming to them where possible.

Id. at 501-02.

Since *Turner* was affirmed by the Sixth Circuit in 1971, there have been at least ten Tax Court decisions holding that there is no income tax consequence in a pure net gift situation. Judge Bryan in the *Hirst* decision cited *Dobson* and stated that failure to follow those Tax Court decisions "seems to me to be a complete disregard of the Supreme Court's directive for treatment of the Tax Court decisions both on the facts and on the law, especially when 'uniform administration would be promoted by conforming to them where possible.' " 572 F.2d at 434. The Tax Court's decisions on net gifts have been uniform in finding no tax on the part of the net gift donor and those findings are supported by the law and the facts and should be followed: "[The Tax Court's] decision, of course, must have 'warrant in the record' and a reasonable basis in the law. But 'the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body'." 320 U.S. at 501.

Although *stare decisis* does not apply here in the technical sense, in view of the lack of a Supreme Court decision directly in point, the net gift position of the Tax Court and the Courts of Appeals for the Fourth, Fifth, and Sixth Circuits was established well before the decision of the Eighth Circuit in this case and we submit it should be

followed here. Justice Brandeis made the point better than we:

> Stare decisis is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right. This is commonly true even where the error is a matter of serious concern, provided correction can be had by legislation.

Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 406 (1932) (citation and footnote omitted).

The *Turner* decision and the subsequent net gift cases are consistent with the theories initially urged by the Commissioner and if *Turner* was incorrectly decided, as the Commissioner asserts, much of the responsibility is his. In *Estate of Staley v. Commissioner*, 47 B.T.A. 260 (1942), *aff'd*, 136 F.2d 368 (5th Cir.), *cert. denied*, 320 U.S. 786 (1943), the taxpayer had contributed corporate stock in trust for the benefit of his children, reserving to himself a specified amount of trust income which he used in paying the gift taxes. The Commissioner determined that the taxpayer had retained an income interest in the property transferred into trust which was taxable to him as ordinary income. The taxpayer claimed that his conveyances were not gifts, but were sales of securities for a purchase price equal to the retained income interest. The Fifth Circuit disagreed:

> The realities of this arrangement are not difficult to ascertain. This was no sale for an inadequate consideration; it was intended to be, and actually was, a gift of the entire corpus and of all the income except an amount necessary to assist in paying the gift taxes. Expressed differently, it was an outright transfer for no consideration, but with a reservation to the donor of a portion of the income.

Id. at 369-70 (footnotes omitted). It is interesting to note that in this case the gift taxes were not paid by the donee; the funds for paying gift taxes were paid back to the donor. Yet, the Commissioner—not the donor— successfully urged that there had been only a gift; that no taxable transfer of the stock had occurred.

Estate of Sheaffer v. Commissioner, 37 T.C. 99 (1961), *aff'd*, 313 F.2d 738 (8th Cir.), *cert. denied*, 375 U.S. 818 (1963), involved the creation of trusts for the benefit of the grantor's children. The trust agreements provided that the trustee was to assume and pay all federal and state gift taxes resulting from the transfers. Dividend income on the gift stock was applied by the trustee in payment of the gift taxes and the Commissioner asserted that the dividend income was taxable income to the donors under section 677 of the Internal Revenue Code.[5] The Tax Court and the Eighth Circuit agreed on the basis of *Estate of Staley v. Commissioner*. The Commissioner did not contend that a sale of the stock had taken place. Indeed, the Commissioner could not make such a claim and still have the income taxable to the grantors as ordinary income under section 677.

In *Estate of Morgan v. Commissioner*, 37 T.C. 981 (1962), *aff'd per curiam*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963), the grantor transferred stock, valued at approximately $1 million, into an irrevocable trust for the benefit of her children and grandchildren. The trust agreement imposed upon the trustees the duty of paying the gift taxes incurred in connection with the gift. The amount of the taxes was determined on a net basis and the resulting gift taxes of approximately $185,000 were paid by the trustee. The trustees borrowed the necessary

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5. I.R.C. §677 provides that income of a trust which may be distributed to the grantor is taxable to him.

funds to pay the taxes in 1956, pledging the gift stock as security for the loan. In 1957 and 1958, the trustees made payments on the loan with dividends received from the stock. The Commissioner asserted that these amounts were taxable to the grantor under section 677.

The Tax Court found that the trustees' obligation with respect to the gift taxes terminated in 1956, when the taxes were paid, and that the grantor thereafter had no further interest in the trust. Accordingly, no portion of the trust income was taxable to her:

> [The donor's] gift tax obligation was paid when due and that is the sole benefit she would have received no matter what method had been chosen by the trustees to obtain funds for this purpose. The manner of obtaining the money was chosen independently by the trustees who were authorized to select whatever method they deemed advisable. Of course, the fact that the trustees chose to obtain money by borrowing and then repaying the loan from income means the trust retained more corpus and less income. This, however, did not benefit the decedent because she retained no interest in the trust and could not recover the corpus. Therefore, since the decedent received no benefit from the fact that the trustees borrowed to discharge her gift tax obligation and repaid the loan from trust income, she cannot be held to have constructively received the income used to repay the loan.

37 T.C. at 985. Once again, the Commissioner made no claim that a sale or other taxable disposition of the stock had been made because to do so would be to defeat his claim that the donor realized ordinary income under section 677. The Commissioner did not even claim that the taxable event was payment of the gift taxes.

The most significant concession of the Commissioner, however, was made in *Turner*. In *Turner*, net gifts had been made to both individual transferees and to trusts created for the benefit of the grantor's grandchildren. The trusts and the individuals agreed to pay the gift taxes. In his brief, the Commissioner conceded that the transfers in trust were in no part sales. 49 T.C. at 362. The primary question presented was whether the transfer to the individuals was a net gift or was a part sale, part gift as argued by the Commissioner. The Tax Court rejected the distinction urged by the Commissioner between the transfers to trusts and those to individuals:

> He distinguishes the two classes of transfers on the basis that the trustees were not personally liable for the tax while the individual transferees personally promised to pay the tax. He concludes that in this latter class of transfers Pamela did not retain any interest in the property transferred but accepted instead the personal promises of the recipients.

Id. at 362-63. The Tax Court found the transfers substantively identical and the claimed distinction artificial and unpersuasive. The Tax Court found as a fact that the donor intended to make a net gift, the value of the shares less the value of the gift tax payable on the transfer, and that her gifts did not result in a taxable gain to her. *Id.* at 363. The *Turner* Court relied upon the earlier decisions in *Estate of Staley v. Commissioner*, *Estate of Sheaffer v. Commissioner*, and *Estate of Morgan v. Commissioner*.

We believe the net gift cases were correctly decided. Furthermore, we believe that thirteen years of tax precedent based upon decisions of the Tax Court should not be reversed, especially when the Commissioner's own theories were largely responsible for that precedent. Finally, we urge that, even if the Supreme Court would find for the

Commissioner if this were a case of first impression, the principles of fair play and *stare decisis* require that such a ruling operate prospectively only, rather than allowing a penalty to fall on petitioners who justifiably relied on *Turner* and its progeny. *See, Chevron Oil Co. v. Hudson*, 404 U.S. 97 (1971).

H. Congressional Action.

In the Tax Reform Act of 1976, Congress considered the possibility of tax avoidance when low basis, highly appreciated property is given to taxpayers in relatively low income tax brackets. Section 644 was added to the Internal Revenue Code to place limited restrictions on this "bracket advantage." Section 644 imposes an additional tax on a trust which sells property within two years after the property is transferred to the trust. The tax is equal to the difference between the tax that would have been imposed on the grantor, had he made the sale, and the tax imposed on the trust.

Thus, the bracket advantage is eliminated in this specific situation. The adoption of Section 644 is highly pertinent to the net gift question in this case. First, Congress imposed the tax only with respect to transfers in trust. Transfers to individuals are unaffected. Second, the additional tax is not imposed until a sale takes place, further recognition of the general principle that sale or conversion of the property must occur before gain is recognized. Third, the tax is not imposed at all if the property is held by the trust for more than two years. The imposition of these limited restrictions on the tax bracket advantage clearly implies that Congress did not feel that further regulation of gifts through the income tax code was necessary or appropriate. Judicial legislation in this area is inappropriate in view of this congressional action.

CONCLUSION

The Eighth Circuit in this case erroneously ruled that the taxpayers in *Grant* and in *Diedrich* recognized substantial economic benefits, taxable to them as income under Subtitle A of the Internal Revenue Code, from the payment of gift taxes by the donees of petitioners' net gifts. The decisions of the Tax Court in *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979), and in *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980), were correct. We request that the decision of the Eighth Circuit in this case be reversed with instructions that the decisions of the Tax Court in favor of the petitioners be reinstated. However, if the Court finds the analysis of the decision below correct, we request that the decision be made prospective only and not applicable to petitioners in this case or to other taxpayers who have justifiably relied upon *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd*, 410 F.2d 752 (6th Cir. 1969).

Respectfuly submitted,

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APPENDIX

INTERNAL REVENUE CODE OF 1954 (U.S.C.)

§ 61. Gross income defined

(a) GENERAL DEFINITION.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) CROSS REFERENCES.—

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

§ 275. Certain taxes

(a) GENERAL RULE.—No deduction shall be allowed for the following taxes:

(1) Federal income taxes, including—

(A) the tax imposed by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act);

(B) the taxes imposed by sections 3201 and 3211 (relating to the taxes on railroad employees and railroad employee representatives); and

(C) the tax withheld at source on wages under section 3402.

(2) Federal war profits and excess profits taxes.

(3) Estate, inheritance, legacy, succession, and gift taxes.

(4) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901 (relating to the foreign tax credit).

(5) Taxes on real property, to the extent that section 164(d) requires such taxes to be treated as imposed on another taxpayer.

(6) Taxes imposed by chapters 41, 42, 43, and 44.

(b) CROSS REFERENCE.—

For disallowance of certain other taxes, see section 164(c).

§ 644. Special rule for gain on property transferred to trust at less than fair market value

(a) IMPOSITION OF TAX.—

(1) IN GENERAL.—If—

(A) a trust (or another trust to which the property is distributed) sells or exchanges property at a gain not more than 2 years after the date of the initial transfer of the property in trust by the transferor, and

(B) the fair market value of such property at the time of the initial transfer in trust by the transferor exceeds the adjusted basis of such property immediately after such transfer,

there is hereby imposed a tax determined in accordance with paragraph (2) on the includible gain recognized on such sale or exchange.

(2) AMOUNT OF TAX.—The amount of the tax imposed by paragraph (1) on any includible gain recognized on the sale or exchange of any property shall be equal to the sum of—

(A) the excess of—

(i) the tax which would have been imposed under this chapter for the taxable year of the transferor in which the sale or exchange of such property occurs had the amount of the includible gain recognized on such sale or exchange, reduced by any deductions prop-

erly allocable to such gain, been included in the gross income of the transferor for such taxable year, over

(ii) the tax actually imposed under this chapter for such taxable year on the transferor, plus

(B) if such sale or exchange occurs in a taxable year of the transferor which begins after the beginning of the taxable year of the trust in which such sale or exchange occurs, an amount equal to the amount determined under subparagraph (A) multiplied by the annual rate established under section 6621.

The determination of tax under clause (i) of subparagraph (A) shall be made by not taking into account any carryback, and by not taking into account any loss or deduction to the extent that such loss or deduction may be carried by the transferor to any other taxable year.

(3) TAXABLE YEAR FOR WHICH TAX IMPOSED.—The tax imposed by paragraph (1) shall be imposed for the taxable year of the trust which begins with or within the taxable year of the transferor in which the sale or exchange occurs.

(4) TAX TO BE IN ADDITION TO OTHER TAXES.—The tax imposed by this subsection for any taxable year of the trust shall be in addition to any other tax imposed by this chapter for such taxable year.

(b) DEFINITION OF INCLUDIBLE GAIN.—For purposes of this section, the term "includible gain" means the lesser of—

(1) the gain recognized by the trust on the sale or exchange of any property, or

(2) the excess of the fair market value of such property at the time of the initial transfer in trust by the transferor over the adjusted basis of such property immediately after such transfer.

(c) CHARACTER OF INCLUDIBLE GAIN.—For purposes of subsection (a)—

(1) the character of the includible gain shall be determined as if the property had actually been sold or exchanged by the transferor, and any activities of the trust with respect to the sale or exchange of the property shall be deemed to be activities of the transferor, and

(2) the portion of the includible gain subject to the provisions of section 1245 and section 1250 shall be determined in accordance with regulations prescribed by the Secretary.

(d) SPECIAL RULES.—

(1) SHORT SALES.—If the trust sells the property referred to in subsection (a) in a short sale within the 2-year period referred to in such subsection, such 2-year period shall be extended to the date of the closing of such short sale.

(2) SUBTITUTED BASIS PROPERTY.—For purposes of this section, in the case of any property held by the trust which has a basis determined in whole or in part by reference to the basis of any other property which was transferred to the trust—

(A) the initial transfer of such property in trust by the transferor shall be treated as having occurred on the date of the initial transfer in trust of such other property,

(B) subsections (a)(1)(B) and (b)(2) shall be applied by taking into account the fair market value and the adjusted basis of such other property, and

(C) the amount determined under subsection (b)(2) with respect to such other property shall be allocated (under regulations prescribed by the Secretary) among such other property and all properties held by the trust which have a basis determined in whole or in part by reference to the basis of such other property.

(e) EXCEPTIONS.—Subsection (a) shall not apply to property—

(1) acquired by the trust from a decedent or which passed to a trust from a decedent (within the meaning of section 1014), or

(2) acquired by a pooled income fund (as defined in section 642(c)(5)), or

(3) acquired by a charitable remainder annuity trust (as defined in section 664(d)(1)) or a charitable remainder unitrust (as defined in sections 664(d)(2) and (3)), or

(4) if the sale or exchange of the property occurred after the death of the transferor.

(f) SPECIAL RULE FOR INSTALLMENT SALES.—If the trust reports income under section 453 on any sale or exchange to which subsection (a) applies, under regulations prescribed by the Secretary—

(1) subsection (a) (other than the 2-year requirement of paragraph (1)(A) thereof) shall be applied as if each installment were a separate sale or

exchange of property to which such subsection applies, and

(2) the term "includible gain" shall not include any portion of an installment received by the trust after the death of the transferor.

§ 677. Income for benefit of grantor

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

(1) distributed to the grantor or the grantor's spouse;

(2) held or accumulated for future distribution to the grantor or the grantor's spouse; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(b) OBLIGATIONS OF SUPPORT.—Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

§ 1001. Determination of amount of and recognition of gain or loss

(a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other dispositionf of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) AMOUNT REALIZED.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) RECOGNITION OF GAIN OR LOSS.—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

(d) INSTALLMENT SALES.—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

(e) CERTAIN TERM INTERESTS.—

(1) IN GENERAL.—In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014 or 1015 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

(2) TERM INTEREST IN PROPERTY DEFINED.—For purposes of paragraph (1), the term "term interest in property" means—

(A) a life interest in property,

(B) an interest in property for a term of years, or

(C) an income interest in a trust.

(3) EXCEPTION.—Paragraph (1) shall not apply to a sale or other disposition which is a part of a

transaction in which the entire interest in property is transferred to any person or persons.

(f) CROSS REFERENCE.—

For treatment of certain expenses incident to the sale of a residence which were deducted as moving expenses by the taxpayer or his spouse under section 217(a), see section 217(e).

Sec. 2501 [1954 Code]. (a) TAXABLE TRANSFERS.—

(1) GENERAL RULE.—A tax, computed as provided in section 2502, is hereby imposed for each calendar quarter on the transfer of property by gift during such calendar quarter by an individual, resident or nonresident.

(2) TRANSFERS OF INTANGIBLE PROPERTY.—Except as provided in paragraph (3), paragraph (1) shall not apply to the transfer of intangible property by a nonresident not a citizen of the United States.

(3) EXCEPTIONS.—Paragraph (2) shall not apply in the case of a donor who at any time after March 8, 1965, and within the 10-year period ending with the date of transfer lost United States citizenship unless—

(A) such donor's loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U. S. C. 1401(b). 1482, 1487), or

(B) such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

(4) BURDEN OF PROOF.—If the Secretary establishes that it is reasonable to believe that an individual's

loss of United States citizenship would, but for paragraph (3), result in a substantial reduction for the calendar quarter in the taxes on the transfer of property by gift, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A shall be on such individual.

(5) TRANSFERS TO POLITICAL ORGANIZATIONS.—Paragraph (1) shall not apply to the transfer of money or other property to a political organization (within the meaning of section 527(e)(1)) for the use of such organization.

(b) CERTAIN RESIDENTS OF POSSESSIONS CONSIDERED CITIZENS OF THE UNITED STATES.—A donor who is a citizen of the United States and a resident of a possession thereof shall, for purposes of the tax imposed by this chapter, be considered a "citizen" of the United States within the meaning of that term wherever used in this title unless he acquired his United States citizenship solely by reason of (1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States.

(c) CERTAIN RESIDENTS OF POSSESSIONS CONSIDERED NONRESIDENTS NOT CITIZENS OF THE UNITED STATES.—A donor who is a citizen of the United States and a resident of a possession thereof shall, for purposes of the tax imposed by this chapter, be considered a "nonresident not a citizen of the United States" within the meaning of that term wherever used in this title, but only if such donor acquired his United States citizenship solely by reason of (1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States.

(d) CROSS REFERENCE.—

(1) For increase in basis of property acquired by gift for gift tax paid, see section 1015(d).

(2) For exclusion of transfers of property outside the United States by a nonresident who is not a citizen of the United States, see section 2511(a).

Sec. 2502 [1954 Code]. (a) COMPUTATION OF TAX.—The tax imposed by section 2501 for each calendar quarter shall be an amount equal to the excess of—

(1) a tentative tax, computed in accordance with the rate schedule set forth in section 2001(c), on the aggregate sum of the taxable gifts for such calendar quarter and for each of the preceding calendar years and calendar quarters, over

(2) a tentative tax, computed in accordance with such rate schedule, on the aggregate sum of the taxable gifts for each of the preceding calendar years and calendar quarters.

(b) CALENDAR QUARTER.—Wherever used in this title in connection with the gift tax imposed by this chapter, the term "calendar quarter" includes only the first calendar quarter of the calendar year 1971 and succeeding calendar quarters.

(c) PRECEDING CALENDAR YEARS AND QUARTERS.—Wherever used in this title in connection with the gift tax imposed by this chapter—

(1) The term "preceding calendar years" means calendar years 1932 and 1970 and all calendar years intervening between calendar year 1932 and calendar year 1970. The term "calendar year 1932" includes only the portion of such year after June 6, 1932.

(2) The term "preceding calendar quarters" means the first calendar quarter of calendar year 1971 and all calendar quarters intervening between such calendar quarter and the calendar quarter for which the tax is being computed.

(d) TAX TO BE PAID BY DONOR.—The tax imposed by section 2501 shall be paid by the donor.